
Pacific Travel Trade School Eligibility to Participate in Title IV Programs

FINAL AUDIT REPORT



**Audit Control Number A0980029
June 1999**

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U.S. Department of Education
Office of Inspector General
Sacramento, California

NOTICE

Statements that financial and/or managerial practices need improvement or recommendations that costs questioned be refunded or unsupported costs be adequately supported, and recommendations for the better use of funds, as well as other conclusions and recommendations in this report, represent the opinions of the Office of Inspector General. Determinations on these matters will be made by the appropriate Education Department officials.



U.S. Department of Education
Office of Inspector General



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MEMORANDUM

DATE: June 11, 1999

TO: Greg Woods
Chief Operating Officer
Office of Student Financial Assistance Programs

FROM: Gloria Pilotti *Gloria Pilotti*
Regional Inspector General for Audit
Region IX

SUBJECT: FINAL AUDIT REPORT
Pacific Travel Trade School
Eligibility to Participate in Title IV Programs
ED Audit Control No. A0980029

Attached is our subject audit report presenting our finding and recommendations resulting from our audit of Pacific Travel Trade School, Los Angeles, California.

In accordance with the Department's Audit Resolution Directive, you have been designated as the action official responsible for the resolution of the finding and recommendations in this report.

If you have any questions or wish to discuss the contents of this report, please contact me at (916) 498-6622. Please refer to the above audit control number in all correspondence relating to this report.

Attachment

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Executive Summary

Pacific Travel Trade School (Pacific Travel), a proprietary institution in Los Angeles, California, did not qualify as an eligible institution for participation in the Title IV Student Financial Assistance Programs. The 1992 reauthorization of the Higher Education Act (HEA) added a provision to the Act requiring that a proprietary institution *"has at least 15 percent of its revenues from sources that are not derived from funds provided under this title [title IV programs], as determined in accordance with regulations prescribed by the Secretary."* This requirement is referred to as the 85 Percent Rule. That is, no more than 85 percent of a proprietary school's revenues, generated from tuition, fees and other institutional charges for eligible programs, may be derived from the Title IV programs.

Pacific Travel received only 9.98 percent of its revenues from non-Title IV sources during its fiscal year ended December 31, 1996. As a result, the institution was ineligible to participate in the Title IV programs as of January 1, 1997. Pacific Travel also failed to meet the 85 Percent Rule in its fiscal year ended December 31, 1997. In that year, the institution derived only 9.80 percent of its revenue from non-Title IV sources.

In the notes to its financial statements for fiscal years 1996 and 1997, Pacific Travel reported that it met the 85 Percent Rule. However, Pacific Travel had improperly included amounts for institutional scholarships in its calculations. The institution also improperly included revenues from an ineligible location. These amounts did not represent non-Title IV cash revenues received by the institution in accordance with Title 34 of the Code of Federal Regulations (CFR), Section 600.5.

We recommend that the Chief Operating Officer (COO) for the Office of Student Financial Assistance Programs take emergency action to terminate the participation of Pacific Travel in the Title IV programs. The COO should require that Pacific Travel return to lenders the Title IV loan funds received after December 31, 1996. In addition, the COO should require that Pacific Travel return to the U.S. Department of Education (Department) the Title IV grant funds received after that date. As of November 30, 1998, Pacific Travel had received \$7.6 million in loans and \$4.4 million in grant funds for periods after the institution became ineligible.

In its comments on the draft report, Pacific Travel did not agree with the finding and recommendations presented. We included Pacific Travel's comments as an attachment to this report.

Qualification of Audit Results

As discussed in the Purpose and Methodology section of this report, Pacific Travel representatives declined to furnish us a management representation letter. The letter acknowledges management's responsibility for the fair presentation of records and reports and asserts that the auditors have been provided with all requested records. It also states that, to the best of management's knowledge, there have been no irregularities or violations of law or regulation in connection with issues covered in the audit scope.

In its comments to the draft report, Pacific Travel stated that it provided us full access to its records and accurate and complete information. However, Pacific Travel failed to acknowledge that, to the best of management's knowledge, there have been no irregularities or violations of law or regulation in connection with issues covered in the audit scope.

Audit Results

We concluded that Pacific Travel did not derive at least 15 percent of its revenues from non-Title IV sources during its fiscal years ended December 31, 1996 and 1997. While the institution reported its percentage of revenue from Title IV programs in the notes of its financial statements, it did not properly calculate the percentage. Pacific Travel understated the percentage of Title IV revenues by improperly including institutional scholarships as non-Title IV revenues when it performed its 85 Percent Rule calculation. The institution also improperly included revenues from an ineligible location in its calculations.

Pacific Travel Failed to Meet the 85 Percent Rule

As of January 1, 1997, Pacific Travel did not qualify as an eligible proprietary institution of higher education because revenues from the Title IV programs exceeded 85 percent of revenues from tuition, fees and other institutional charges. The 1992 reauthorization of the HEA added a provision to the Act requiring that a proprietary institution "*has at least 15 percent of its revenues from sources that are not derived from funds provided under this title [title IV programs], as determined in accordance with regulations prescribed by the Secretary.*"¹ This institutional eligibility requirement is set forth in Title 34 CFR Section 600.5(a)(8). The regulations provide the formula for assessing whether an institution has satisfied the requirement and specify that amounts used in the formula must be received by the institution during its fiscal year. Specifically, 34 CFR Section 600.5(d)(2)(i) states that ". . . the title IV, HEA program funds included in the numerator and the revenue included in the denominator are the amount of title IV, HEA program funds and revenues received by the institution during the institution's last complete fiscal year;"

Pacific Travel's receipts from non-Title IV sources were less than 15 percent of its revenues. The following table summarizes our analysis of revenues for Pacific Travel. The amounts shown are for Pacific Travel's fiscal years ending December 31. The non-Title IV receipts comprise of cash received from student payments, Job Training Partnership Act program and Vocational Rehabilitation programs.

¹ This provision was contained in the HEA, Section 481(b)(6). The 1998 amendments to the HEA, which were enacted on October 7, 1998, changed the provision to require that a proprietary institution has at least 10 percent of its revenue from non-Title IV sources.

Table 1. OIG's Computation of Pacific Travel's Percentage of Non-Title IV Funds. In fiscal years 1996 and 1997, Pacific Travel did not have sufficient non-Title IV revenues to meet the 15 percent minimum.

Pacific Travel Trade School			
Revenue Received	1995	1996	1997
Title IV Receipts	\$1,108,773	\$3,425,094	\$4,719,950
Non-Title IV Receipts	212,637	379,792	512,865
Total Revenue (Cash Basis)	\$1,321,410	\$3,804,886	\$5,232,815
Non-Title IV Funds as a Percent of Total Revenue	16.09%	9.98%	9.80%

Table 1 shows that the non-Title IV revenues represented less than 10 percent of Pacific Travel's total revenues for fiscal years 1996 and 1997. This is substantially less than the required minimum of 15 percent. Proprietary institutions that fail to satisfy the 85 Percent Rule lose their eligibility to participate in Title IV programs on the last day of the fiscal year covering the period that the institution failed to meet the requirement. Therefore, the institution was ineligible to receive Title IV funds as of January 1, 1997.

Pacific Travel improperly included amounts in its 85 Percent Rule calculations that did not represent non-Title IV revenue received. When Pacific Travel calculated its percentage of revenues from non-Title IV sources in fiscal years 1996 and 1997, it improperly included its institutional scholarships. The institution also improperly included revenues from an ineligible location in its calculations. These items gave the impression that Pacific Travel met the required percentage of Title IV revenues for the 85 Percent Rule. However, as noted in the previous section, it had not met the requirement. The following table shows the amounts that Pacific Travel included in its computations:

Table 2. Pacific Travel's Computation of its Percentage of Non-Title IV Funds. *The inclusion of Pacific Travel's institutional scholarships and the Houston school's revenues gave the impression that Pacific Travel met the 85 Percent Rule for fiscal years 1996 and 1997.*

Pacific Travel Trade School			
Revenue Received	1995	1996	1997
Title IV Revenue	\$ 1,108,773	\$ 3,425,094	\$ 4,668,582 ²
Other Revenue:			
Scholarships	-0-	105,412	182,863
Houston School	-0-	220,180	245,775
Other	212,637	379,792	568,638 ²
Total Other Revenue	\$ 212,637	\$ 705,384	\$ 997,276
Total Revenue (Title IV and Other)	\$ 1,321,410	\$ 4,130,478	\$ 5,665,858
Other Revenue as a Percent of Total Revenue	16.09%	17.08%	17.60%

Amounts used in the 85 Percent Rule calculation must represent revenue received. Title 34 CFR Section 600.5(d)(2)(i) specified that the amounts to be used in the calculation are Title IV funds and **revenues received** by the institution during the fiscal year. The Financial Accounting Standards Board (FASB) provides a definition of revenue in its Statement of Financial Accounting Concepts No. 6. The FASB defines revenues as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations." The FASB Statement also states that "Revenues represent actual or expected cash inflows (or the equivalent) that have occurred or will eventuate as a result of the entity's ongoing major or central operations."³ The accounting method that recognizes revenues when amounts are received is referred to as cash-basis accounting.⁴

When the regulation covering the 85 Percent Rule was issued on April 29, 1994, the Department stated its position on including institutional scholarships as revenue. In the *Analysis of Comments and Changes* section of the Final Rule, the Secretary stated that:

² The title IV receipts and non-Title IV cash receipts shown in Tables 1 and 2 for fiscal year 1997 differ due to computation errors made by Pacific Travel. Pacific Travel used separate sources for the numerator and denominator in the 85 percent rule formula. A report prepared by its school servicer was used for the numerator (net Title IV receipts). The deposit records for the school's operating bank account was used for the denominator (total receipts). Pacific Travel's calculations include adjustments to the amounts derived from the servicer reports and bank deposits so that the amounts would reflect actual receipts received for instruction during the fiscal year. As a result of its computation errors, Pacific Travel understated the numerator (net Title IV receipts) by \$51,368 and overstated its denominator (total receipts) by \$55,773.

³ FASB's Statement of Financial Accounting Standards No. 95 defines "cash equivalents" as short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

⁴ In contrast, the accrual basis of accounting recognizes revenue when sales are made or services are performed, regardless of when cash is received.

"An institution is not prohibited from including institutional charges that were paid [emphasis added] by institutional scholarships . . . as revenue . . . provided that the scholarships are valid and not just part of a scheme to artificially inflate an institution's tuition and fee charges The Secretary does not consider institutional scholarships to be valid if every student receives such a scholarship so that no student ever pays the claimed tuition and fee charges"

While the preamble does indicate that institutional scholarships could be included, the preamble also states the institution must account for revenue on a cash basis of accounting. The regulation stresses that revenue used in the calculation must be received.

Institutional scholarship amounts included in Pacific Travel's calculations do not represent revenue received. Since 1996, Pacific Travel's Board of Directors has awarded institutional scholarships to students. The school's scholarship policy requires that the scholarship recipients have an outstanding tuition balance, complete their educational program and maintain an 80 percent grade point average.

Pacific Travel used the following transactions to record the scholarships in student accounts, servicer records and the school's accounting records. Pacific Travel prepared checks from a bank account designated for scholarships for an amount that was equal to the scholarship recipients' outstanding tuition balance. The scholarship checks were made payable to Pacific Travel. Pacific Travel recorded these checks as a payment on the recipients' ledger card and the school's servicer system records. Periodically, Pacific Travel would transfer sufficient funds from its operating bank account to the scholarship bank account to cover a group of scholarship checks. Then, Pacific Travel would promptly deposit the scholarship checks into its operating bank account. Pacific Travel reported scholarship expenses of \$105,412 and \$182,783 in fiscal years ended 1996 and 1997, respectively.

Pacific Travel's institutional scholarships do not represent revenue. Pacific travel did not have an external source for scholarship funds. The scholarships did not provide inflows of cash or other assets. In fact, the scholarship transactions are only cash transfers between two of the institution's bank accounts. The institutional scholarships should not have been included in the institution's 85 Percent Rule calculations.

Revenues used in the 85 Percent Rule calculation must be for tuition, fees or other institutional charges for students enrolled in an eligible program. Title 34 CFR Section 600.5(d)(1) specifies that the revenues in the denominator of the 85 Percent Rule formula be generated by the institution from institutional charges of students enrolled in eligible programs as defined in 34 CFR 668.8. Specifically, paragraphs (a)(1) and (2) of Section 668.8 states that ". . . An eligible program is an educational program that—(1) Is provided by a participating institution; [emphasis added] and (2) Satisfies the other relevant requirements contained in this section."

The eligibility notice establishes the extent of an institution's eligibility to participate in Title IV programs provided by the Department.⁵ Further, an institution cannot decide the extent of its eligibility to participate in Title IV programs.⁶ A basic requirement for an educational institution to qualify for eligibility under the HEA is accreditation by an agency or association that the Secretary recognizes as a reliable authority to determine the quality of education or training offered by an institution.⁷

Pacific Travel included payments from students who attended an ineligible location. In its 85 Percent Rule calculation, Pacific Travel included revenue received from students attending a campus in Houston, Texas.⁸ Pacific Travel school catalog shows that the Houston campus offered vocational training for x-ray technicians. Pacific Travel included Houston campus revenues of \$220,180 and \$245,775 as non-Title IV revenues in its 85 Percent Rule calculations for fiscal years 1996 and 1997, respectively.

Revenue received from students attending training courses at the Houston campus cannot be included in Pacific Travel's 85 Percent Rule calculation. The Program Participation Agreement (eligibility notice) that Pacific Travel received from the Department does not list the Houston campus as a location eligible for participation in Title IV programs. Also, the Houston campus would not be eligible to become an approved location for participation in Title IV programs because the Houston campus is not accredited by an accrediting agency.

Pacific Travel was ineligible for Title IV funds it received since January 1, 1997. Because it did not meet the 85 Percent Rule for its fiscal year ended December 31, 1996, Pacific Travel lost its eligibility to participate in the Title IV programs on January 1, 1997. The following table shows the amounts of Title IV funds that, as of November 30, 1998, Pacific Travel had received since its loss of eligibility.

⁵ Title 34 CFR Section 600.10(b)(2) states that "If the Secretary determines that only certain educational programs or certain locations of an applicant institution satisfy the applicable requirements of this part, the Secretary extends eligibility only to those educational programs and locations that meet those requirements and identifies the eligible educational programs and locations in the eligibility notice sent to the institution under § 600.21."

⁶ Title 34 CFR Section 600.10(c)(2) states that "If, as part of its institutional eligibility application, an institution indicates that it does not wish to participate in any title IV, HEA program and the Secretary determines that the institution satisfies the applicable statutory and regulatory requirements governing institutional eligibility, the institution is eligible to apply to participate in any HEA program listed by the Secretary in the eligibility notice it receives under § 600.21." However, the institution is not eligible to participate in those programs, or receive funds under those programs, merely by virtue of its designation as an eligible institution under this part."

⁷ Title 34 CFR 600.5(a)(6) states that "A proprietary institution of higher education is an educational institution that—Is accredited; . . ."

⁸ Pacific Travel's owners opened the Houston location to students in January 1993. Since its inception, the Houston location has not participated in the Title IV, HEA programs.

Table 3. Title IV Funds Received by Pacific Travel after January 1, 1997.⁹ *Pacific Travel received over \$11 million in Title IV program funds after it became ineligible to participate in those programs.*

Pacific Travel Trade School			
Title IV Program	Fiscal Year Ended December 31, 1997	January 1 through November 30, 1998	Total
Pell Grant	\$2,001,659	\$2,296,737	\$4,298,396
Supplemental Educational Opportunity Grant	37,664	77,807	115,471
Total Grant	\$2,039,323	\$2,374,544	\$4,413,867
Family Federal Education Loans:			
Stafford Loan (subsidized)	1,660,930	1,525,092	3,186,022
Stafford Loan (unsubsidized)	2,147,562	2,018,570	4,166,132
SLS Loan	2,971	6,790	9,761
PLUS Loan	90,873	18,165	109,038
William D. Ford Direct Loans:			
Direct Loan (subsidized)	33,087	(1,213)	31,874
Direct Loan (unsubsidized)	41,717	(222)	41,495
Perkins Loan	9,831	1,699	11,530
Total Loans	\$3,986,971	\$3,568,881	\$7,555,852
Total Title IV Funds	\$6,026,294	\$5,943,425	\$11,969,719

Recommendations

We recommend that the Chief Operating Officer of the Office of Student Financial Assistance Programs:

1. Initiate emergency action to terminate the participation of Pacific Travel in the Title IV programs.
2. Require that Pacific Travel return to lenders the Title IV loan funds received after December 31, 1996. Pacific Travel records show that, as of November 30, 1998, the school had received a total of \$7.6 million of loans.

⁹ The grant and loan amounts shown in Table 3 are the total funds received as shown by Pacific Travel's records.

3. Require that Pacific Travel return Pell Grant and Federal Supplemental Educational Opportunity Grant funds received after January 1, 1997. As of November 30, 1998, Pacific Travel's records showed that those grant funds total \$4.4 million.

Pacific Travel Comments

Pacific Travel disagreed with our conclusion that the institutional scholarship amounts should not be included in the 85 Percent Rule calculation. Pacific Travel stated that it offered a valid scholarship program and that the preamble to the regulations supports its treatment of accounting for scholarships as revenues. It stated that no where in the preamble is the argument that the word "paid" meant an inflow of revenue or cash from a source external to the institution. Also, Pacific Travel stated that the accounting method specified in the regulations was not a pure cash-basis. Its claim was based on a statement in the preamble concerning the use of institutional matching funds when calculating the 85 Percent Rule percentage.

In its response, Pacific Travel referred to the hierarchy of Generally Accepted Accounting Principles (GAAP), which establishes the order for the most authoritative sources of guidance for an auditor. Under this hierarchy, Pacific Travel claimed the Industry Audit Guide for Audits of Colleges and Universities issued by the American Institute of Certified Public Accountants (AICPA) was a higher authoritative source than the FASB Statement of Financial Accounting Concepts No. 6 that was cited in the report.

Pacific Travel claimed that the AICPA Guide supported its method for recording scholarships. The AICPA Guide instructs institutions to record all tuition and fee waivers as expenditures and to classify the expenditures as scholarships. Further, the AICPA Guide provides that tuition and fees should be recorded as revenue even though there is no intention of collection from the students. Pacific Travel further stated that industry practices support its position of recording scholarships as revenue received and asserted that the Secretary had established his own regulatory basis of accounting.

Pacific Travel claimed that its scholarship amount for FY 1996 was about \$52,000 and not the \$105,412 as shown in its audited financial statements for FY 1996. To support the revised amount, Pacific Travel provided a school official's oral declaration and a confirmation letter from a bank representative.

Pacific Travel did not agree that payments from students who attended an ineligible location could not be included in the 85 Percent Rule calculation. Pacific Travel stated that the educational program (limited medical radiologic technologist or LMRT) was offered at the Houston school and is an approved program on its Program Participation Agreement. Pacific Travel claimed that since the Houston school is owned by Pacific Travel, the payments from the Houston students should be considered as revenue from an eligible program for the purpose of the 85 Percent Rule calculation. In its response to the draft report, Pacific Travel acknowledged that its Houston location was not accredited or eligible to participate in the Title IV programs.

OIG Response

Pacific Travel's comments did not change our position that the institutional scholarships should not be included in the 85 Percent Rule calculation. While not all students receive institutional scholarships, there are other aspects of Pacific Travel's scholarship program that raise questions concerning the program's validity.

1. It appears that Pacific Travel implemented the scholarship program for the sole purpose of meeting the 85 Percent Rule. Pacific Travel implemented its scholarship program in 1996, the year that it did not have sufficient cash receipts to meet the 85 Percent Rule.
2. We found no evidence that Pacific Travel made students aware of its institutional scholarship policy or that they received a scholarship. The school catalog did not mention the availability of institutional scholarships. For the period of our review, we found no evidence that the institution used a scholarship notification form or other document to inform students of the scholarship requirements or that scholarships were awarded to the students. The only evidence that the student received a scholarship was an entry on the student's ledger card.
3. The scholarships are only available to students who owe tuition and fees to the institution. This means that students whose tuition and fees were fully covered by Title IV funds would not be eligible for the scholarships.
4. The scholarship policy specifies that the institution's owners can change the minimum grade point average (GPA) required for students to qualify for the scholarship. Thus, the institution can lower the GPA when it needs more non-Title IV revenue during its fiscal year or increase the GPA when it needs less. In its response to the draft report, Pacific Travel stated that it could have increased its use of institutional scholarships to obtain the required non-Title IV revenue if it had believed that revenue from the Houston school could not be used in the calculation.

Our position is that Pacific Travel's institutional scholarships are not revenues received. Section 600.5(d)(2)(i) of the CFR specifically states that ". . . the title IV, HEA program funds included in the numerator and the revenue included in the denominator are the amount of title IV, HEA program funds and revenues received by the institution" The Secretary was explicit in the preamble that institutions use "cash-basis of accounting" or revenues actually received. Also, in the notice of proposed rulemaking to implement the 85 Percent Rule, the Secretary stated his intent was to "encourage proprietary institutions to obtain non-Federal, non-loan student aid funds from independent outside sources."

Pacific Travel's basis for the statement that cash-basis, in the context of the regulation, does not mean pure cash-basis is flawed. In the preamble to the regulations, the Secretary did state that matching funds should not be included in the numerator of the calculation. However, the absence of a statement regarding the denominator does not negate other statements contained in the preamble. As noted above and in the report, the Secretary made a clear statement in the preamble that institutions must use a cash-basis of accounting for amounts included in the 85 Percent Rule calculation. Under a cash-basis of accounting, the institution's matching funds are not revenue.

The OIG is aware of the hierarchy of GAAP. The AICPA's Audit and Accounting Guide: Not-for-Profit Organizations, effective on January 1, 1996, superseded the AICPA Guide cited in Pacific Travel's response. The definition of revenue contained in the FASB Statement of Financial Accounting Concepts No. 6 is used in the Not-for-Profit Guide.

The National Association of College and University Business Officers (NACUBO) provides the preferred industry practice for recording revenues and scholarships. NACUBO instructs institutions to report tuition and fee revenues net of scholarship allowance (tuition waivers). Revenues, as defined by NACUBO, are the amounts received to satisfy student tuition and fees. NACUBO further defines revenues as only amounts actually received from students and third-party payers to satisfy student tuition and fees. Pacific Travel is incorrect in its claim that industry supports its practice of recording scholarships as revenue.

Pacific Travel's claim that the Secretary had established his own regulatory basis of accounting has no merit. The regulations issued by the Secretary only specified a methodology for calculating a percentage that is to be reported in a footnote of the institution's audited financial statement, not an other comprehensive basis of accounting.

Pacific Travel did not provide sufficient evidence to support its claim that the FY 1996 scholarship expense amount was \$52,000. Pacific Travel's audited financial statement reported \$105,412 as scholarship expense, and Pacific Travel claimed the \$105,412 of scholarship expenses as a deduction in its 1996 income tax return. Pacific Travel has not filed an amended income tax return or reissued its financial statement to reflect a change in its net income and retained earnings for fiscal year 1996. In addition, Pacific Travel has not complied with our request to provide the bank statements for its scholarship account.

Pacific Travel's comments did not change our position on the inclusion of revenues from an ineligible location in the 85 Percent Rule calculation. The Program Participation Agreement defines the extent of an institution's participation in the Title IV HEA programs. Since the Houston school was not listed in Pacific Travel's Program Participation Agreement, it cannot be considered a part of the participating institution. Therefore, the program offered at the Houston school was provided by an ineligible segment of Pacific Travel's business operations and did not meet the regulatory definition for an eligible program. Pacific Travel's eligibility does not extend to the Houston school so the revenues should not be included in the denominator of the 85 Percent Rule calculation.

Other Matters

During our fieldwork, we met with representatives of the Certified Public Accounting (CPA) firm that audited Pacific Travel's financial statements for the fiscal year ended December 31, 1997. Our purpose was to obtain information on the extent of the CPA firm's review of amounts included in Pacific Travel's 85 Percent Rule calculation and its basis for concluding that the calculation was properly performed by the institution.

The CPA firm's representative explained that his review included tracing the amounts used in the 85 Percent Rule calculation to the institution's general ledger and bank records. The representative stated that, in his opinion, the amounts used in Pacific Travel's calculation were proper and reconciled to the school's records. As noted in our report, Pacific Travel's scholarships did not represent revenues and should not have been included in the 85 Percent Rule calculation. Also, Pacific Travel improperly included the revenues from an ineligible location in the calculation.

Background

Pacific Travel was founded in 1963 and offers vocational programs in the travel, health and business fields. The current owners purchased the school in April 1994. Pacific Travel has a main campus in Los Angeles, California, and other approved locations in Long Beach, Inglewood, and Huntington Park, California. These locations are accredited by the Accrediting Commission of Career Schools and Colleges of Technology. In 1993, Pacific Travel started a school in Houston, Texas, which offered training in x-ray technology. The Houston campus was closed in April 1998. The Houston school was not accredited and did not participate in the Title IV programs. Pacific Travel uses the services of R. Gonzalez Management Inc. (RGM), a third-party school servicer.

During the period January 1, 1997, through November 30, 1998, Pacific Travel received about \$12 million in Title IV funds from the following programs: Federal Pell Grant, Federal Supplemental Educational Opportunity Grant, Federal Family Education Loan, William D. Ford Direct Loan, and Federal Perkins Loan.

Purpose and Methodology

The purpose of our audit was to determine if Pacific Travel derived at least 15 percent of its revenues from non-Title IV sources and properly reported its 85 Percent Rule percentage in its financial statements and if applicable, to the U.S. Department of Education.

To accomplish our objective, we obtained background information about the institution and identified the Department's Office of Postsecondary Education number under which the institution received its Title IV funds. We reviewed Pacific Travel's corporate financial statements and the most recent Student Financial Assistance audit reports prepared by its Certified Public Accountants. We conducted interviews with Pacific Travel officials and reviewed student records. We assessed whether the institution used the 85 Percent Rule formula in the regulations and reviewed the financial statements for proper disclosure of the percentage.

To achieve our audit purpose, we analyzed data extracted from Pacific Travel's manual student account ledgers and RGM reports, which were maintained on a computerized database. Information from student account ledgers that was used as a basis for our audit conclusion was tied to other sources, such as institutional bank statements and student records. We used data extracted from the Department's National Student Loan Data System (NSLDS) for comparative purposes and reports generated from the Department's Postsecondary Education Participants System (PEPS) for background information purposes.

Our audit covered the institution's fiscal year ending December 31, 1997. After determining that Pacific Travel did not meet the 85 Percent Rule in fiscal year 1997, we expanded our review to include the 85 Percent Rule calculation methodology used for fiscal years ended December 31, 1995 and 1996. For these prior years, we evaluated the types of revenues used in the calculation.

We performed fieldwork at Pacific Travel's corporate office and main campus from August 12, 1998 through August 27, 1998. Additional work was completed in our Long Beach office through October 30, 1998. Our audit was performed in accordance with generally accepted government auditing standards appropriate to the scope of the review described above.

Pacific Travel officials declined to sign a management representation letter (see Qualification of Audit Results in the Executive Summary of the report). Pacific Travel's refusal to provide us with a management representation letter raises questions as to the completeness of the information provided to us, thereby causing us to qualify the results of our audit.

Statement on Management Controls

As part of the review, we assessed Pacific Travel's management control structure, and its policies, procedures, and practices applicable to the scope of the audit. The purpose of our review was to assess the level of control risk for determining the nature, extent, and timing of our substantive tests. For this report, we assessed management controls related to the institution's calculation and reporting of its percentage of revenues from Title IV sources as required by the 85 Percent Rule.

Because of inherent limitations, a study and evaluation made for the limited purposes described above would not necessarily disclose all material weaknesses in the control structure. However, our assessment disclosed material weaknesses in the procedures used to calculate and report the percentage. These weaknesses are discussed in the Audit Results section of this report.

Attachment

Pacific Travel Trade School's Response to the Report

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April 2, 1999

VIA OVERNIGHT MAIL

Ms. Gloria Pilotti
Regional Inspector General for Audit
Region IX
U.S. Department of Education
Office of Inspector General
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Sacramento, CA 95814

Re: Pacific Travel Trade School, Los Angeles, CA

Dear Ms. Pilotti:

As you know, this Firm represents the Pacific Travel Trade School ("PTTS") in Los Angeles. Please find attached PTTS' written comments and response, with exhibits, to the proposed Office of Inspector General report (ACN A0980029). In this connection, we appreciate your courtesy in providing PTTS with the opportunity to file these comments.

In the Statement on Purpose and Methodology section, it states that PTTS officials declined to sign a management letter which raised questions as to the completeness of the information provided. PTTS does not believe this is an accurate statement of the facts and does not believe the OIG has any reason to question the completeness of the information provided.

In particular, the record should be clear that PTTS acknowledged that it is responsible for the fair representation of documents, records and other information provided to your auditors for their audit. PTTS also stated its belief that the information provided to your auditors during the course of the audit was accurate and complete. The fact that PTTS choose not to provide a letter in exactly the form requested does not support the conclusion that they declined to provide a management representation letter or a basis to question the completeness of the information provided.

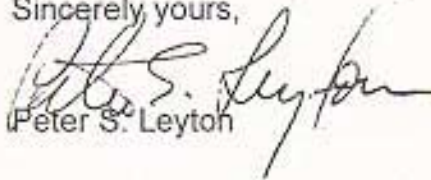
To reiterate, PTTS submits that it has provided full access to its records and

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Ms. Gloria Pilotti
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accurate and complete information. If you have any questions, please feel free to contact me.

Sincerely yours,


Peter S. Leyton

PSL/
Enclosure

fc: Lora Osher

PACIFIC TRAVEL TRADE SCHOOL'S
RESPONSE TO THE OFFICE OF
INSPECTOR GENERAL'S
AUDIT REPORT
ACN A0980029

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**PACIFIC TRAVEL TRADE SCHOOL'S
RESPONSE TO THE OFFICE OF INSPECTOR
GENERAL'S DRAFT AUDIT REPORT
ACN A0980029**

I.
PRELIMINARY STATEMENT

On January 28, 1999, the Office of Inspector General ("OIG") issued a draft audit report to Pacific Travel Trade School ("PTTS"), Audit Control Number A0980029 ("Draft Audit", *Exhibit 1*). The audit focused solely upon PTTS' compliance with what is commonly referred to as the 85 Percent Rule.¹

The Draft Audit concludes that PTTS' percentage of revenue from Higher Education Act ("HEA") programs funded or authorized under title IV of the HEA of 1965, as amended ("Title IV"), in the fiscal year ended December 31, 1996 was 90.02 percent and that it was 90.20 percent in the fiscal year ended December 31, 1997, *Exhibit 1* at page 3. In contrast, the School's financial statements, as certified by its accountants, reported that 84.79 percent and 82.4 percent of the revenue was from Title IV, HEA programs, for fiscal years 1996 and 1997, respectively. *Exhibits 2 and 3*.

The significant differences between the percentages reported by the Institution and those calculated by the OIG are the result of the OIG excluding all reported institutional scholarship revenue and all revenue from an x-ray technician program offered by PTTS at its Houston, Texas. The Draft Audit recommends that the Office of Student Financial Assistance take an emergency action to terminate PTTS' participation in the Title IV programs and seek the return from PTTS of about \$12 million in Title IV grants and loans disbursed since January 1, 1997. *Exhibit 1* at page 7.

For all of the reasons advanced below, PTTS submits that the OIG conclusions and recommendations are unfounded, inappropriate and disproportionately harsh.

II.
BACKGROUND

PTTS is a participating proprietary institution of higher education with a main location in Los Angeles and approved additional locations in Long Beach, Huntington Park and Inglewood, California. *Exhibits 4 & 5*. PTTS, Inc., which is a corporation owned by several individuals including its president, Lora Osher,

¹ Under the 85 Percent Rule, at least 15 percent of a proprietary school's revenue had to be derived from non-Title IV sources. 20 U.S.C. § 1088(b)(6)(section 481(b)(6) of the HEA) and 34 C.F.R. § 600.5(a)(8). In October 1998, the HEA was reauthorized as part of which this provision was amended to require that at least 10 percent of a proprietary school's revenue has to be derived from non-Title IV sources. Section 102 of the Higher Education Amendments of 1998.

and Dr. Michael Giventer, owns PTTS. *Exhibit 6, ¶ 2 & Exhibit 7, ¶ 2*. This acquisition took place in 1994. PTTS offers approved educational programs designed to prepare individuals for gainful employment in recognized occupations in the health and travel industries. There are presently about 630 students enrolled in programs at PTTS and about 120 people employed as faculty and staff. *Exhibit 6, ¶ 5*.

In late 1992, Dr. Giventer, a chiropractor, founded the Health Education & X-Ray Institute of Houston, Texas ("HEXI"). *Exhibit 7, ¶ 2*. HEXI was created to train individuals for employment as x-ray technicians. In 1995, the separate corporations that owned PTTS and HEXI merged. *Exhibit 6, ¶ 4 & Exhibit 7, ¶ 2*. Operationally, HEXI was by choice a branch of PTTS, but not one that was accredited or eligible to participate in the Title IV programs. Legally, the two corporate entities merged leaving only one surviving entity, PTTS, Inc. *Exhibits 8, 9 & 10*.

III. THE 85 PERCENT RULE

The 85 percent rule ("Rule") was enacted in 1992. It provided that proprietary institutions of higher education must derive "at least 15 percent" of their revenues from non-Title IV sources. Section 481(b)(6) of the HEA. According to the Secretary, a principal purpose of the law is to require proprietary institutions to attract students based on the quality of their programs, not because they offer Title IV aid. *Exhibit 11, 59 Fed. Reg. 6446, 6448 (Feb. 10, 1994)*.

Final regulations were promulgated on April 29, 1994. Congress, however, delayed their effective date to July 1, 1995. Pub.L.103-333; see 34 C.F.R. § 600.5(a)(8). The regulations require all proprietary institutions to disclose the percentage of their revenue derived from Title IV, HEA programs, as defined at section 600.5(d), in a footnote to their annual audited financial statements. 34 C.F.R. § 668.23(d)(4).

The Secretary requires a proprietary institution to determine the percentage of its revenue from Title IV and non-Title IV sources by dividing the amount of Title IV funds the institution used to satisfy tuition, fees and other institutional charges by the sum of revenues generated by the institution from tuition, fees and other institutional charges for students enrolled in eligible programs as defined in 34 CFR § 668.8. See 34 C.F.R. § 600.5(d)(1)(emphasis added).

Revenue is defined in terms of what has been received by the institution during the last complete fiscal year. *Id.* at § 600.5(d)(2)(i). In the notice of proposed rulemaking ("NPRM") to implement this provision, the Secretary briefly discussed his interpretation of the term "revenue." *Exhibit 11, 59 Fed. Reg. at*

6448. He opted for what he regarded as a "middle ground between counting only the income received from students' tuition and fees and counting as revenue income from businesses that are owned and operated by the institution, regardless of the relationship between the educational institution and the businesses." *Exhibit 12*, 59 Fed. Reg. 22324, 22327-328 (April 29, 1994).

In the final regulation, the Secretary stated that institutions are to use a cash basis of accounting for title IV, HEA program funds, and revenue. *Exhibit 12* at 22324, 22328. Cash basis in the context of the regulation and prevalent industry practice does not mean pure cash basis accounting. *Exhibits 13 at 3 & 14 at 2-3*. For example, the Secretary said that institutional matching funds, such as are required under the Federal SEOG and Federal Perkins programs, could not be included in the numerator of the fraction as part of the Title IV funds. *Exhibit 12* at 22327. On the other hand, the statement clearly implies that these funds can be included in the denominator as non-Title IV revenue. Significantly, the matching funds, which come from the institution's operating account or earned revenue and not from a new external source of revenue, are in character the same as the scholarship funds being challenged by the OIG in the draft report.

Apart from these few comments, however, the Secretary provided no guidance regarding the interpretation of the term "revenue".

IV.

PTTS PROPERLY INCLUDED INSTITUTIONAL SCHOLARSHIPS AS NON-TITLE IV REVENUE IN ITS DENOMINATOR

The OIG asserts that PTTS should not have included institutional scholarships that it awarded to students in both fiscal years as non-Title IV revenue in the denominator of the 85 percent calculation. The OIG maintains that the institutional scholarships were not "revenue received" as defined in § 600.5(d)(2)(i). *Exhibit 1* at page 4-5. This conclusion is based on a definition of revenue set forth in Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Concepts No. 6. *Exhibit 1* at 4. The FASB Concept defines revenue as "actual or expected cash inflows (or the equivalent)". *Id.*²

² Consistent with its position in this case, the OIG has taken a similar position in cases involving the inclusion of institutional loans in the year when the loans are made rather than when the payments are received by the institution. The Secretary's only comment in this regard was that evidence of repayment on loans was necessary in order to demonstrate that the loans were "real". *Exhibit 12* at ¶22328. The OIG's position is inconsistent however, with the limited guidance that the Department has given on this issue. Specifically, on at least two occasions the Department's policy division responded to inquiries on this issue by affirming that the institution could include in the denominator the full amount of the loan when made. *Exhibit 18*. As with scholarships, the institutional loans do not reflect actual cash inflows yet the Department has expressly permitted their inclusion in the 85 percent calculation. While the OIG may be consistent in its position, the Department's practice has been to the contrary. Under these circumstances, it is entirely inappropriate for the OIG to seek to penalize PTTS for good faith actions consistent with past Departmental interpretations of the term "revenue".

PTTS' scholarship program is based on a set of very specific criteria. *Exhibit 15, ¶¶ 7-8.* In the Draft Report, it is clear that the OIG does not question, nor have any basis to question, the scholarship program's legitimacy. The financial mechanics that PTTS established to award a scholarship involved funding a scholarship account by contributing funds to this account from its earnings in its operating account. Upon the award of a scholarship, a check was written from the scholarship account to PTTS in order to establish a clear audit trail. *Exhibit 15 at ¶¶ 5 & 9.*

PTTS recorded these checks as payment (revenue received) on the student's ledger card and the School's servicer's computer system records. Because the scholarship funds came from PTTS' earnings (i.e., the institution that is the source of the institutional scholarship) and not a source external to the institution, the OIG asserts that no cash inflows occurred and, therefore, the scholarship amounts (\$105,412 and \$182,783 in fiscal years 1996 and 1997, respectively) should not have been included in the 85 percent calculation for those years. *Exhibit 1 at 5.*³

PTTS Offers A Valid Scholarship Program

PTTS began its institutional scholarship program in 1996. *Exhibit 15 at ¶ 3.* PTTS understood from reading the preamble to the final 85 Percent Rule regulations and from other sources that the Secretary considered institutional scholarships to be a legitimate means of meeting the 85/15 requirement, so long as the scholarship program was not a sham. *Id.*

Shortly before implementing the program, PTTS discussed the plan and its conclusions with its third party servicer, RGM & Associates. *Id.* at ¶ 6. While initially unsure, RGM was accepting of the plan only after PTTS showed it the Secretary's comments in the preamble to the regulations. *Id.* PTTS realized that the scholarship program must have specific criteria. It also realized that the program could not be oriented toward an entire class of individuals such as all second year students.⁴ *Id.* at ¶ 7.

To qualify for consideration, PTTS' policy provides: 1) that a student has to graduate from his or her program of study with a minimum grade point average of 80 percent, 2) has to have an outstanding balance, 3) has to be unable to pay

³ The correct scholarship amount for FY 1996 is about \$52,000 not \$105,412. *Exhibit 15 at ¶ 11.*

⁴ PTTS obtained additional guidance regarding the establishment and handling of scholarship programs during a workshop conducted by the Department of Education. Specifically, Ms. De Anne Williams and Dr. Giventer attended such a workshop in Dallas, Texas, in May 1995. *Exhibits 7 at ¶ 3, 15 at ¶ 4 & 16.* At that workshop, the presenters emphasized that scholarships were not to be issued to every student and that schools needed to develop criteria to objectively administer their programs. The presenters also counseled schools to create a separate account – apart from their operating account – in order to segregate funds available for the scholarship program. *Exhibits 7 at ¶ 5 & 15 at ¶ 5.*

the balance, and 4) has to request the scholarship. *Exhibit 15 at ¶ 8 & Exhibit 17.* PTTS understood that to meet these requirements, it also had to create a clear audit trail. *Exhibit 15 at ¶ 9 and footnote 2.*

In 1996, PTTS had about 526 graduates of whom 93 or about 18% received scholarships. *Exhibit 15 at ¶ 10.* In 1997, about 770 students graduated of whom 66 or about 9% received scholarships. *Id.* In 1998, 733 students graduated of whom 78 or about 11% received scholarships. *Id.* Similarly, a review of the dollars awarded for scholarships compared to accounts receivable also shows that the percentage of money devoted to scholarships is very low. *Id.* at ¶¶ 11-12. Clearly, PTTS' scholarship program is a valid and legitimate program intended to help needy students.

The Preamble To The Regulations Supports PTTS' Treatment Of The Funds And The Calculation

The preamble to the final 1994 regulations contains very little guidance with respect to the meaning of revenue and the use of institutional scholarship. What the Secretary did say that is of relevance was that

"an institution is not prohibited from including institutional charges that were paid by institutional scholarships and institutional loans as revenue in the denominator of the fraction...provided that the scholarships and loans are valid and not just part of a scheme to artificially inflate an institution's tuition and fee charges." 59 Fed. Reg. 22324 (April 29, 1994), *Exhibit 12.*

The OIG has focused on the word "paid" in this statement to support its argument that the Secretary meant an inflow of revenue or cash from a source external to the institution. *Exhibit 1 at 5.* Nowhere in the preamble, however, is this argument. Of course, it would have been very simple for the Secretary to have made such a statement.

In fact, the preamble supports just the opposite interpretation. Specifically, the Secretary's explicitly states that institutional matching funds may be excluded from the numerator of the fraction without commenting on the denominator is also in the preamble. *Exhibit 12 at 22327.* The character of these matching funds is no different than the character of the institutional scholarship funds. That is, both are derived from the institution and not from any new or external source. In that sense, neither represents a new "inflow of revenue". See also *footnote 2.*

Statement of Financial Accounting Concepts No. 6 Does Not Establish A Standard

In preparing its response to the Draft Audit, PTTS engaged the services of two independent accounting firms, West & Company of Oklahoma City, OK, and

Salmon Beach & Company of Dallas, TX, to provide opinions. *Exhibits 6 at ¶ 9, 13 at 6 & 14.* Neither of these companies had worked for PTTS prior to this engagement. *Exhibit 6 at ¶ 10.*

Both accounting firms have had substantial experience, developed over many years, preparing financial statements for proprietary institutions of higher education. Both firms are also very familiar with the applicable regulations and the limited guidance issued by the Department. Both firms satisfactorily meet OIG standards as evidenced by the Quality Control Reviews of their work by the OIG and have good reputations among their colleagues in the accounting community and among proprietary institutions.

Statement of Financial Accounting Concepts No. 6 ("SFAC 6") upon which the OIG relies, states in its preamble that the:

"Statements of Financial Accounting Concepts do not establish standards prescribing accounting procedures or disclosure practices for particular items or events, which are issued by the Board as Statements of Financial Accounting Standards. Rather, Statements in this series describe concepts and relations that will underlie future financial accounting standards and practices and in due course serve as a basis for evaluating existing standards and practices." *Exhibit 13 at Appendix 1 at 4 & Exhibit 14, Attachment 1 at 1 (emphasis added).*

Notwithstanding this clear pronouncement that the Concepts are not standards, the OIG cites SFAC 6 for the proposition that it is "the standard" to support all of its conclusions about the inappropriateness of including the revenue from the school's institutional scholarships in the calculation. As pointed out by both West & Co. ("West") and Salmon Beach & Company ("Salmon"), the accounting profession has an established hierarchy of Generally Accepted Accounting Principles ("GAAP"). See *Statements on Auditing Standards ("SAS") No. 69, Exhibit 13 at 2 and Appendix 2 at 6 and Exhibit 14 at 3, Attachment 2 at 398.*

Under this hierarchy, auditors are expected to look to the sources of information identified in the hierarchy for guidance in conducting an audit and to rely, as much as possible, on the sources of information that provide guidance that are at the lowest Level of the hierarchy. *Exhibit 13 at 2-3 and Exhibit 14 at 3-5.*

So, for example, the most authoritative sources of guidance for an auditor performing a specific audit are at "Level 1". If guidance is not available at "Level 1", it is expected that the auditor will look to "Level 2" for guidance and so on up the ladder. *Id.* Guidance found at Level 5, which is the level where the Concepts are found, is the least authoritative material. *Exhibit 13 at 2-3 and Exhibit 14 at 2-5.* Reliance on the Concepts in the manner that the OIG has used them would

be acceptable only if there is no other guidance available at a lower level. As shown below, however, other more appropriate and authoritative sources of guidance do exist at lower levels of the hierarchy.

Reliance on SFAC 6 is also misplaced because it is a statement written and intended to provide thoughts for future financial accounting in terms of GAAP. *Exhibit 14 at 3, Attachment 1.* GAAP represents accounting principles intended to assist with the preparation of accrual based presentations of financial information. *Id.* Since the 85/15 and now 90/10 analysis is supposed to be cash based accounting, reliance on SFAC 6 is misplaced. Again, SFAC 6 is not a standard and not a document upon which the OIG can properly rely for the conclusion that PTTS' revenue from institutional scholarships cannot be included in the 85/15 calculation.

AICPA Industry Audit Guide for Audits Of Colleges and Universities Supports PTTS' Practice

West and Salmon agree that no authoritative guidance exists at "Level 1" of the hierarchy. They point out, however, that authoritative guidance exists at both "Level 2" and "Level 4". *Exhibits 13 & 14.*

At "Level 2" of the hierarchy AICPA Industry Audit Guides are cited as an important source document. *Exhibit 13 at 2.* At "Level 4", "Prevalent Industry Practices" are also cited as an appropriate source for guidance. *Id.* Each of these sources is more appropriate and persuasive sources than Concepts at "Level 5".

The AICPA Industry Audit Guide for Audits of Colleges and Universities ("AGACU") was prepared to assist independent auditors in auditing and reporting on financial statements of nonprofit institutions of higher education. *Exhibits 13 at Appendix 3 & Exhibit 14 at Attachment 3.* Notwithstanding the audit guides focus on nonprofit institutions, it is very instructive with respect to the treatment of fee waivers and scholarships for two reasons.

First, the Guide provides that all tuition and fee waivers or remissions should be recorded as expenditures and classified as Scholarships. *Exhibit 14 at 4.* Tuition and fees should be recorded, according to the Guide, as revenue even though there is no intention of collection from the student.⁵ Scholarships are defined by the Guide as expenditures in the form of "outright grants to students selected by the institution and financed from current funds, restricted or unrestricted." *Id.*

⁵ The Department's cash management regulations, and cash reimbursement requirements in particular, also require institutions to include as revenue and disbursements any amounts posted to a student's credit on a ledger card even if no actual funds have been disbursed. 34 C.F.R. § 668.162(d)(1).

Second, the Department has adopted the Audit Guide's definition of scholarships and the appropriate practice of recording tuition and fees in its IPEDS (Integrated Postsecondary Education Data System) instructions to participating institutions including proprietary institutions. *Exhibit 14 at 4, Attachment 4*. IPEDS is a financial survey form that all participating institutions are required to complete. *Id.* Instructions for the completion of line 1, tuition and fees, contain the requirement that institutions "[i]nclude tuition and fee remissions or exemptions even though there is no intention of collecting them from the student."

PTTS' treated scholarship funds in a manner identical to the direction and description contained in the Guide and IPEDS. (In fact, PTTS has followed the IPEDS guidance and included Houston revenue in its IPEDS report since 1996. *Exhibit 15 at ¶ 12*. PTTS selected students through applicable criteria and, accordingly, waived some portion of their institutional charges. These waivers were appropriately classified as scholarships and recorded on ledger cards as "revenue received", as directed by the Guide, even though there was no intention to collect any funds from the students. The scholarships were financed from a fund made up of dollars transferred to it from PTTS' operating account. PTTS' operating account is equivalent to a nonprofit institution's current funds account.

PTTS Followed Prevalent Industry Practices by Including Scholarship Revenue in the 85/15 Calculation

"Level 4" of the hierarchical table identifies "prevalent industry practices" as another source of guidance if no guidance exists at earlier Levels. *Exhibit 13 at 3 & Exhibit 14 at 5*. As Salmon and West both state, prevalent industry practice is to award scholarships from operating accounts or a special fund established, as PTTS did. *Exhibits 13 and 14*. It is also to record scholarships as revenue in the same manner that PTTS followed, consistent with the Audit Guide and IPEDS. Finally, it is to include this revenue in the 85/15 calculation. In fact, the practice PTTS followed has been in place within this industry for many years before and predates 85/15.

Accordingly, when the Secretary said in the preamble to the final regulations that institutional charges may be paid by institutional scholarships, that statement was interpreted by proprietary institutions and auditors familiar with the industry to mean a continuation of the practice that had been in place for many years. This was also a practice identical to that followed by nonprofit institutions. *Id.*

By definition, an institutional scholarship is revenue provided by the institution from its own funds to selected students that results in a reduction in institutional charges owed by those students. Had the Secretary meant that the only revenue that could be recognized in the calculation was "new" revenue "from a source external to the institution" such as would be generated by an

endowment fund, he could have said so. In fact, given prevalent industry practices, it would have been incumbent on him to forewarn institutions since this approach would represent a fundamental change from prevalent industry practice.

Similarly, institutions could also look at his comments regarding institutional matching funds and guidance regarding institutional loans and conclude that the inclusion of institutionally generated funds in the denominator was proper. As such, it would have been especially important for proprietary institutions (the only institutions affected by this issue) to understand the Department's expectation since the concept of new and external sources of funding for scholarships such as endowment funds is generally a foreign concept to proprietary institutions.

Other Guidance Also Supports PTTS' Inclusion of Institutional Scholarship Revenue in the Calculation

Finally, West and Salmon looked at a Guide to Preparing Financial Statements, Volume 2, Chapter 9, "Cash and Tax Bases and Other Comprehensive Bases of Accounting". *Exhibits 13 at 3, Appendix 4 & Exhibit 14 at 5, Attachment 5*. In Chapter 9, "Other Comprehensive Bases of Accounting" ("OCBOA"), five bases of accounting other than accrual are described. *Id.* These five bases are pure cash, modified cash, tax basis, regulatory basis and other basis.

"Regulatory basis" is the basis of accounting that the reporting entity uses to comply with financial requirements of a governmental regulatory agency to whose jurisdiction the entity is subject. *Exhibit 13*. An example of this would be the Department of Education. In this context, the regulatory basis would be the standards and guidance of the Department.

As previously noted, however, the Department has provided virtually no guidance with respect to interpreting 85/15. In the absence of guidance from the Department, PTTS' reliance on prevalent industry practice, which parallels AICPA Audit Guidelines, was especially reasonable and appropriate. The AICPA Audit Guidelines at "Level 2" clearly indicate that there is no requirement for "inflows" of cash. *Exhibit 14 at 4*. Prevalent industry practices also do not call for external sources of funding or inflows of cash. They treat revenue from scholarships in exactly the manner PTTS followed. Lastly, and most importantly the Secretary expressly permits the use of scholarships in the denominator so long as the program was a valid scholarship program. *Exhibit 12 at 22328*.

Based on all of these considerations, PTTS' use of institutional scholarships to pay institutional charges and to include the revenue from these scholarships in the denominator should be accepted as proper, justified and done in good faith reliance on the Secretary's limited guidance.

V.
PTTS' INCLUSION OF REVENUE FROM THE
HOUSTON CAMPUS WAS REASONABLY AND
RATIONALLY BASED

The OIG argues that since Houston was not a location at which enrolled students could obtain Title IV aid, revenue from the students enrolled in a program at that location cannot be included in PTTS' 85/15 calculation. *Exhibit 1* at pages 5-6. While the OIG might consider this an obvious point, the fact is that PTTS had a reasonable and rational basis to conclude that revenue from students enrolled in an otherwise eligible program that was being provided by an otherwise participating institution could be included in the denominator of the 85/15 fraction.

In anticipation of the 85 percent rule going into effect in July 1995, PTTS considered what methods it could properly employ to maintain compliance. *Exhibit 6* at ¶¶ 8-15 & *Exhibit 15* at ¶ 13. PTTS read the regulations as well as the preamble to the regulations. Among other things, it wondered whether it could count revenue from a cash-paying branch in the denominator of the 85/15 fraction. *Exhibit 6* at ¶ 11 & *Exhibit 15* at ¶¶ 13-14. In May 1995, De Anne Williams and Dr. Michael Giventer attended a pre-certification training session offered by the Department in Dallas. *Exhibits 7, 15 & 16.*

During the training session, they posed the question noted in the immediately preceding paragraph. *Exhibits 7* at ¶ 6 & *Exhibit 15* at ¶ 15. In response, Departmental officials stated that the programs offered at the cash paying institution, i.e. an ineligible location, must be eligible programs. *Id.* They then asked whether the revenue from students enrolled in an eligible program provided by a participating institution at the cash paying location could be included in the 85/15 calculation. *Id.* The response was that if the program offered at the cash paying location was an eligible program, the revenue could be counted in the 85/15 calculation of the participating institution. *Id.*

Additionally, PTTS considered the language of the 85 Percent Rule and the specifically referenced regulations. *Exhibits 6, 7 & 15.* Specifically, the 85 percent rule states that the denominator of the fraction may include revenues "for students enrolled in eligible programs as defined in 34 CFR § 668.8". 34 C.F.R. § 600.5(d)(1). An eligible program is defined by the Department as an educational program that "is provided by a participating institution" and "satisfies other relevant requirements contained in this section". 34 C.F.R. § 668.8(a)(emphasis added). For example, an educational program provided by a participating institution must meet certain minimum length requirements and provide undergraduate training that prepares a student for gainful employment. 34 C.F.R. § 668.8(d).

A participating institution is an institution that meets the standards for participation in Title IV and has a current program participation agreement with the Department. 34 C.F.R. § 668.2(b). PTTS meets those standards and has a current PPA. *Exhibits 4, 5 & 6 at ¶ 3*. Its locations in Los Angeles, Long Beach, Huntington Park and Inglewood, are recognized by the Department as "eligible locations" meaning that students who are enrolled in eligible programs at these locations may be eligible to receive federal student financial aid under Title IV. 34 C.F.R. § 668.32(a)(1). PTTS does not maintain and has never maintained or represented that the Houston location is or was an eligible location for Title IV funding purposes.

PTTS' analysis, supported by the Department's presenters at the training session, led it to conclude that it could include revenue from a cash paying branch in its denominator if it as a participating institution offered or provided an eligible program. *Exhibits 6, 7 & 15*. In July 1995, PTTS and HEXI merged. *Exhibits 6, 7, 8, 9 & 10*. The revenue that the OIG proposes to exclude from the denominator of the 85/15 fraction is from a program provided by PTTS in Houston and commonly referred to as the x-ray technician program. *Exhibit 1* at page 6. Its proper name is the Limited Medical Radiologic Technologist program ("LMRT"). *Exhibits 5 at page F1, 25, & 27*. The program has a CIP code of 51.0907. *Exhibit 26*. Through training in this program, a person can become certified to administer radiation treatments to patients under the supervision of a physician. *Exhibits 6 & 7*.

Following the merger with HEXI, PTTS began the costly process to design curriculum and obtain state and federal approvals for an LMRT program. It did not obtain its own authorization to include this program within its eligibility, within the meaning of 34 C.F.R. § 668.8, until 1996. *Exhibits 6 & 15*. Because the x-ray technician program was not approved at PTTS until 1996, PTTS did not include any revenue from Houston in its FY 1995 calculation. *Id.* During this period, PTTS also absorbed losses at Houston. *Id.*

The confusion regarding the inclusion of revenue from Houston stems from the intermixing of two different concepts. Namely, an eligible program being offered at an eligible location for purposes of students obtaining Title IV aid and the simple offering of an otherwise eligible program by a participating institution, PTTS, at a location of the school that is not eligible for Title IV aid. Since the program at issue is an eligible program and since it was provided by a participating institution, albeit at an ineligible location, PTTS, its accountants and even some Departmental officials interpreted the law to permit the inclusion of the revenue from students enrolled in that program in the denominator of the fraction.

Were this program offered at an eligible location, there is no question that the revenue could be included in the 85/15 fraction. The fact that it was offered at an ineligible location was not considered to be of consequence in terms of the

inclusion of revenue for 85/15 purposes. It was thought that this would only have been of consequence if students at that location had sought and obtained Title IV aid. In fact, PTTS' action in this regard is the ultimate confirmation that one of the main purposes of the Rule, that students will enroll in a program because of its quality not because they can obtain Title IV aid, can be achieved.

PTTS and its accountants concluded that the Department could have easily written that the revenue from an eligible program could only be included in the fraction if the program was offered "at" an "eligible location". Critically, none of the regulatory definitions require that the program be offered *at* a participating institution.

PTTS' conclusion from reviewing the eligible program regulation and the preamble to the final regulations was that the revenue from the program could be included in the 85/15 calculation. PTTS submits that its interpretation and action were reasonable in light of the regulatory language and specific references, the preamble to the final regulation, the guidance given to it and the lack of any other clear guidance from the Department. Similarly, it is also of significance that two independent CPAs certified that PTTS' 85/15 calculations for fiscal years 1996 and 1997, which included the revenue from this program in Houston, were properly calculated. *Exhibits 2 & 3*. Had PTTS thought otherwise, it could have easily avoided the costs of the merger and of obtaining approval for the LMRT program at PTTS. Instead, it could have used other methods to obtain the required non-Title IV revenue including increased use of institutional scholarships. See *section IV above*.⁶

PTTS is entitled to rely on its reasonable, good faith interpretations as well as the accountant certifications. Similarly, and in the absence of fraud or bad faith, PTTS should not be told, after the fact, that its interpretation is not only wrong, but also cause for huge liabilities and loss of eligibility.

According to the Draft Audit, PTTS included about \$220,180 in revenue from this program in the 1996 calculation and about \$245,775 in revenue from this program in the 1997 calculation. *Id.* No revenue from this program was included in the calculation for fiscal year 1995 or fiscal year 1998. PTTS has also decided to no longer include revenue from this program in any future calculations. *Exhibit 6 at ¶ 15*.

⁶ Under 34 CFR § 600.9, the Secretary recognizes that an eligible institution may contract with an ineligible institution and students attending the ineligible institution may receive Title IV aid. In this case, no Title IV aid was disbursed to any of the students who attended the Houston location. Nevertheless, the OIG maintains that the relationship between the eligible and ineligible institutions cannot be recognized for 85/15 purposes even when the applicable regulation (sec. 668.8) is at the very least ambiguous and when an otherwise eligible program is offered by what is otherwise a participating institution. To say the least, the logic supporting the first situation but not the second is missing. Were section 600.9 applied by analogy and 25% of the revenue recognized, about \$55,045 in FY 1996 and \$61,444 in FY 1997 funds could be included in the denominator of the fraction. See *resulting percentages at page 13*.

VI. CONCLUSION

PTTS has demonstrated that the scholarship funds it contributed to its students in FY 1996 and FY 1997 may be included as non-Title IV revenue in the denominator of the 85/15 fraction. This conclusion is fully supported by the Secretary's statement in the preamble to the final regulations, prevalent industry practice, the AICPA Audit Guide for Audits of Colleges and University and other Departmental statements such as IPEDS, cash management regulations and training session representations. This conclusion is also supported by application of the correct accounting standard which, in this matter, is not pure cash based accounting but rather a regulatory basis of accounting.

PTTS has also demonstrated that its inclusion of the revenue from Houston was made in good faith reliance on its own analysis of the regulations, including the specific provisions cited in the 85/15 regulation, the preamble to the regulations and the advice of Departmental trainers. Clearly, had PTTS not reached this conclusion, it would not have proceeded to incur the additional costs to merge with Houston, to subsidize Houston and to obtain an eligible program that it could provide in Houston. Certainly, PTTS also relied on the certifications of its accountants who agreed with the calculations for both years.

For all of these reasons, the OIG should withdraw its draft recommendations and accept PTTS' participation in Title IV for both fiscal years. If the OIG cannot accept the rates represented in the financial statements as fair, reasonable or accurate, the OIG should nevertheless conclude that it is inappropriate and unfair to seek to penalize PTTS on these facts and under these circumstances. This position is particularly appropriate since both PTTS and its accountants acted in good faith with little to no guidance from the Department. Institutions such as PTTS are facing what amounts to life or death circumstances arising out of their reasonable interpretations of regulatory requirements. PTTS is entitled to some flexibility in light of the fact that they acted in good faith and the Department utterly failed to provide sufficient guidance.

Without suggesting an abandonment of the above arguments and conclusions, PTTS notes that, if the scholarship funds remained in the calculation for FY 1996 but the revenue from Houston were excluded, PTTS' Title IV revenue for FY 1996 would still be below the threshold at 84.25 percent. *Exhibit 19*. Were 25 percent of the revenue from Houston included (per the section 600.9 analogy), the percent of Title IV aid would decline to 83.57 percent. *Exhibit 20*. Thus, under any reasonable analysis, PTTS was eligible to participate in the Title IV, HEA programs, in fiscal year 1997.

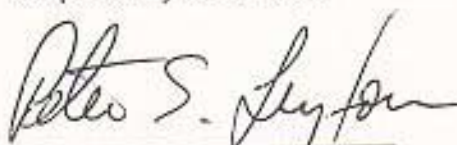
Were PTTS' reported scholarship revenue included in FY 1997 and the Houston revenue excluded, PTTS' Title IV revenue for FY 1997 would have been 86.55 percent. *Exhibit 21*. Were 25 percent of the revenue from Houston included (per the section 600.9 analogy) PTTS' Title IV revenue would have been 85.53 percent. *Exhibit 22*.

In October 1998, the Higher Education Amendments of 1998 were enacted. For fiscal years ending after October 1, 1998, proprietary institutions are now required to demonstrate that they derive no more than 90 percent of their revenue from Title IV, HEA programs. *Exhibit 23, statement of Jeff Baker, Director, Policy Development Division*. Not only is this a significant prospective change, but it also evidences a congressional intent with respect to this issue that has relevance to enforcement for periods prior to fiscal year 1998.

For fiscal year 1998, PTTS' Title IV revenue, *without scholarship or Houston revenue*, is 83.39%. *Exhibit 24*. PTTS was also below the 90 percent threshold for fiscal years 1996 and 1997 with the inclusion of scholarship revenue. In consideration of these facts, the clear policy implications associated with the 1998 amendment, PTTS' percent of Title IV revenue and PTTS' good faith effort to comply with the regulatory requirements, PTTS submits that the proposed recommended actions are without merit and inappropriate.

Finally, PTTS notes that negotiated rulemaking to implement the 1998 amendments is presently underway and that some of the specific issues involved in this draft audit, such as the meaning of "revenue" and whether scholarship funds can be included in the denominator when no new inflows of cash exist, will be addressed by the team. In consideration of this fact and the further fact that some of the highly relevant issues in this draft report will be addressed by regulations to be promulgated later this year, PTTS submits that it is inappropriate for the OIG to pursue the issuance of a final report at this time.

Respectfully submitted,



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Date: April 2, 1999

**U.S. Department of Education
Office of Inspector General Note**

The exhibits of Pacific Travel Trade School's response are available in our office and will be provided upon request.

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